Directorate of Intelligence

Secret

25X1

Mexico: High Costs of Maintaining Austerity

25X1

An Intelligence Assessment

Secret

ALA 83-10128
August 1983

Copy 302

Sanitized Copy Approved for Release 2011/01/10 : CIA-RDP84S00552R000300170004-6

Page Denied

Directorate of
Intelligence

Secret [redacted]

25X1

Mexico: High Costs of Maintaining Austerity [redacted]

25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office of African and Latin American Analysis. It was coordinated with the Directorate of Operations. Comments and queries are welcome and may be directed to the Chief, Middle America–Caribbean Division, ALA, [redacted]

25X1

25X1

Secret
ALA 83-10128
August 1983

25X1

Mexico: High Costs of Maintaining Austerity

25X1

Key Judgments

Information available as of 1 August 1983 was used in this report.

De la Madrid's efforts to bring domestic spending in line with Mexico's resources have yielded some financial results, but they have nearly derailed the domestic economy. To meet IMF targets thus far, Mexico City has cut government spending by about 20 percent, in large part by slashing public-sector imports. The large peso devaluation and disrupted trade financing lines also helped keep imports in the first half of 1983 at rockbottom levels, 60 percent below the level a year earlier. 25X1

Harsh austerity has also sharply reduced economic activity:
- Real GDP fell at an annual rate of 6 percent during January-June.
- Bankruptcies and job losses have multiplied.
- Real wages and personal incomes have plummeted.

Meanwhile, consumer price inflation is running at an annual rate of about 100 percent and wholesale prices are up more than 130 percent over last year. 25X1

Recent headway on Mexico's foreign accounts has encouraged the international financial community somewhat. Nevertheless, bankers remain skeptical about the government's ability and willingness to provide foreign exchange to pay private debt obligations. Defaults on private Mexican debt will probably cost US bankers $3-4 billion over the next year or so. 25X1

Determination and skillful negotiating tactics have gained the President the support of organized labor and earned him the grudging cooperation of business and the middle class. The unions' primary goal has been to maintain jobs for members, and—so far at least—most employment cutbacks have occurred among less skilled, unorganized labor. Private businesses have been pleased with wage restraints and the President's low-key, down-to-business style. Nevertheless, they are concerned about the absence of an explicit role for private enterprise and about de la Madrid's economic policy initiatives. 25X1

It is likely to be much harder to maintain a consensus on the austerity program for the rest of the year.
- Continuing to meet IMF targets means no rebound in private business activity, further deep government spending cuts, and a substantial reduction in the public-sector payroll.

Sanitized Copy Approved for Release 2011/01/10 : CIA-RDP84S00552R000300170004-6

25X1

- Many Mexican economists and opposition politicians are already arguing that the adjustments have gone far enough.
- Further trimming of spending for food and transportation subsidies and the public work force will directly affect politically powerful interest groups.

Even so, de la Madrid appears willing to test the limits of what is necessary to stay in compliance with the IMF stabilization program. He is strengthening the austerity program he introduced last December with tough initiatives on wages, food staple subsidies, and administrative policies. 25X1

On balance, we believe the chances probably are somewhat better than even that concern over the high domestic costs will lead Mexico City to seek adjustments in IMF restrictions as early as the next few months. Requests for concessions on the public-sector deficit, expansion of the money supply, and overseas borrowing are likely in an effort to hold the fall in employment and consumption to politically acceptable limits. At a minimum, Mexico City is likely to press hard for relaxation of IMF terms for the remaining two years of its three-year program. 25X1

In any case, we believe the economy will continue to decline during the rest of this year.

- Even if Mexico eases up on austerity, we project that economic activity will still fall about 5 percent.
- If de la Madrid holds firm, econometric analysis indicates an 8-percent drop in GDP this year. 25X1

Moving into 1984, the economy will be better positioned to meet its financial needs than at any time in the past 18 months, but the degree of improvement—and subsequent prospects for GDP growth—hinge on the rigor with which austerity is pursued in the interim. Because of the greatly reduced imports in the first half of this year, enough foreign financing is already available for Mexico to boost imports and stimulate the economy, but we believe the likely outcome would ultimately be more rapid inflation and another financial crisis. Maintaining the austerity program for the rest of the year, however, would put Mexico in a more favorable foreign exchange position to achieve some economic growth in late 1984 without rekindling triple-digit inflation. 25X1

25X1

The prospects of prolonged austerity and a continued decline in consumption almost surely will put pressures on domestic stability and will cloud US-Mexican economic and political relations for at least the next two years. Bilateral economic relations since de la Madrid took office last winter have improved substantially. Nevertheless, heavy US financial losses will continue, and grating bilateral episodes—such as an expropriation of some properties owned by US firms or additional debt moratoriums—are still possible. Meanwhile, illegal migration to the United States will remain at record levels. 25X1

25X1

Contents

Page Denied

25X1

Table 1
Mexico: Foreign Financing Gap

Million US $

	1975	1980	1981	1982 [a]	1983		
					Jan-Jun [a]	Jul-Dec [b]	Jul-Dec [c]
Trade balance	−3,159	−1,471	−3,003	7,802	6,550	3,250	6,950
Exports, f.o.b.	3,540	17,015	20,927	22,224	10,550	11,250	10,950
Oil and gas	464	10,306	14,441	16,362	7,500	7,500	7,500
Manufactures	1,831	3,726	3,797	3,742	1,900	2,400	2,100
Agriculture	892	1,544	1,481	1,233	650	750	750
Minerals	353	1,439	1,208	887	500	600	600
Imports, f.o.b.	6,699	18,486	23,930	14,422	4,000	8,000	4,000
Net services and transfers	−1,284	−5,290	−9,541	−10,486	−4,650	−5,650	−5,350
Interest	−1,437	−5,437	−8,383	−10,879	−4,750	−5,650	−5,650
Current account balance	−4,443	−6,761	−12,544	−2,684	1,900	−2,400	1,600
Debt amortization due	1,058	5,984	6,310	8,500	4,000	4,000	4,000
Financial gap	−5,501	−12,745	−18,854	−11,184	−2,100	−6,400	−2,400
Medium- and long-term capital inflows	5,431	12,460	18,006	16,698 [d]	5,500 [d]	20,500 [d]	17,500 [d]
Net short-term capital (errors and omissions)	215	1,173	1,962	−8,514	−2,400 [e]	13,100 [e]	−13,100 [e]
Changes in reserves	145	888	1,114	−3,000	1,000	1,000	2,000
Other financial items							
External debt (at yearend)	17,600	50,700	74,900	80,800	NA	86,800	83,800
Short term	5,200	11,100	22,500	23,200	NA	10,000	10,000
Debt service ratio (*percent*)							
Due	35.0	45.6	47.7	63.1	56.3	59.4	60.5
After debt relief	35.0	45.6	47.7	46.8	36.9	40.9	41.7

[a] Estimated.
[b] Assumes Mexican policymakers relax austerity, increasing imports and public spending.
[c] Assumes Mexico City keeps imports and public-sector spending at rockbottom rates through 1983.
[d] Includes $4 billion in 1982, $1 billion in the first half of 1983, and $5 billion in the second half of 1983 in debt relief on medium- and long-term debt principal due; and $1 billion in the first half of 1983 and $12 billion in the second half of 1983 in rescheduling of short-term into long-term obligations.
[e] Includes rescheduled short-term debt and arrears, and in capital flight.

25X1

25X1

Mexico: High Costs of Maintaining Austerity

25X1

Introduction

The future course of the Mexican economy is of key concern to the United States. Most important, the length and depth of the current economic crisis will strongly influence the course of political stability for our southern neighbor. The crisis also raises the risk of large US bank losses, sharply reduced US exports, and heavy losses by the US business community operating in Mexico. In addition, it holds the prospect of amplifying existing US-Mexican bilateral problems, such as the crossing of illegal migrants into the United States.

This paper discusses the performance of the Mexican economy in the first six months of 1983 and examines likely macroeconomic outcomes for the remainder of the year. It considers de la Madrid's far-reaching economic policy changes, including sharp hikes in the relative prices of energy, many consumer goods, and foreign exchange, and a simultaneous reduction in real wages and business profits. It looks into the dilemma the President now faces in deciding whether to ask Mexicans to continue bearing the harsh burdens of austerity and hold fast to the IMF program, or to ease up on austerity. The study also analyzes the effects of a politically palatable adjustment in economic policy on the pace of recovery.

Austerity Bites Deep

Meeting IMF Targets

De la Madrid has been moderately successful in managing his austerity program by devaluing the peso, restraining wages, cutting government spending, and freeing most price controls. In May, the IMF characterized austerity implementation as forceful, and—based on preliminary data—judged Mexico in compliance with first-quarter program objectives. More recently, the US Embassy indicated that Mexican officials expect to attain second-quarter targets as well—but by a much less comfortable margin.

Mexico City has managed to cut the budget deficit to some 10 percent of GDP despite a falloff in tax revenues. The 1983 budget mandated a 20-percent real cut in spending not related to debt service and a 20-percent increase in revenues. Actual spending totals, which are down as a result of trimmed capital goods imports, appear to be at or below target, and the government has just announced further sharp reductions in food subsidies. Government revenues, 25X1 however, have sagged with lower world oil prices and declining receipts from retail and income taxes.

Implementation of the IMF austerity program has 25X1 slashed foreign purchases generally and enabled Mexico to meet its external financial targets and build foreign exchange reserves somewhat. We estimate that Mexican imports during January-June were 60 percent below the level during the same period in 1982. This boosted Mexico's trade surplus to $6.6 billion during the first half of the year, allowed $4.8 billion in interest payments on the foreign debt, and pushed the current account into surplus. Capital flight continued—but at levels that were more than offset by the new foreign loans allowed under the stabilization program. 25X1

Domestic Economic Tailspin

Output. Financial restraints have provoked growing 25X1 domestic economic problems, however. We calculate—based on import, consumption, and investment trends, early industrial statistics, and econometric studies—that economic activity fell at an annual rate of about 6 percent during January-June. 25X1

Import shortages have hit industrial production hardest. Continuing price controls on basic commodities and shortages of imported raw materials, intermediate goods, machinery, and spare parts have eliminated profits for many firms and led to numerous bankruptcies and plant shutdowns. A May poll by a private-sector business association showed that 76 percent of

25X1

The IMF Targets

Mexico City will find it increasingly difficult to meet IMF domestic targets in the second half of this year, in large part because the public sector will have to bear a greater share of the burden. Trimming public- sector spending further will require additional reductions in food and transportation subsidies and smaller payrolls. Moving in this direction presents policymakers with a difficult choice. Without the cuts, especially in the face of depressed government tax revenues, we—and Mexican policymakers—believe that Mexico City cannot achieve its budget deficit target. On the other hand, inflation is eating away at the purchasing power of budget allocations, and reducing the real level of public services. The next round of budget cuts will hit especially hard at the urban poor and public employees—groups that the administration fears may spark sudden violence. In the next few months, we expect the more powerful ministries to use budget overruns in an effort to maintain their programs. We also see public employment unions and their organized labor allies applying strong pressures to persuade Mexico City to retreat from firing the thousands of employees that it would take to stay within budget limits. Success in either area will cause the budget deficit to rise above the target. 25X1

Mexico City will be hard pressed in its efforts to hold down rapid expansion of domestic credit in the face of higher-than-projected inflation and any expansion of the budget deficit. The IMF program restricts nominal increases in credit from the Bank of Mexico to both the public and private sectors to 34 percent for all this year. To achieve this in the face of triple-digit inflation would require a real cut in the money supply of 35 to 40 percent. Such a credit crunch would boost bankruptcies by further depleting private sector working capital and, in our estimation, also lower government consumption and employment below politically acceptable levels. 25X1

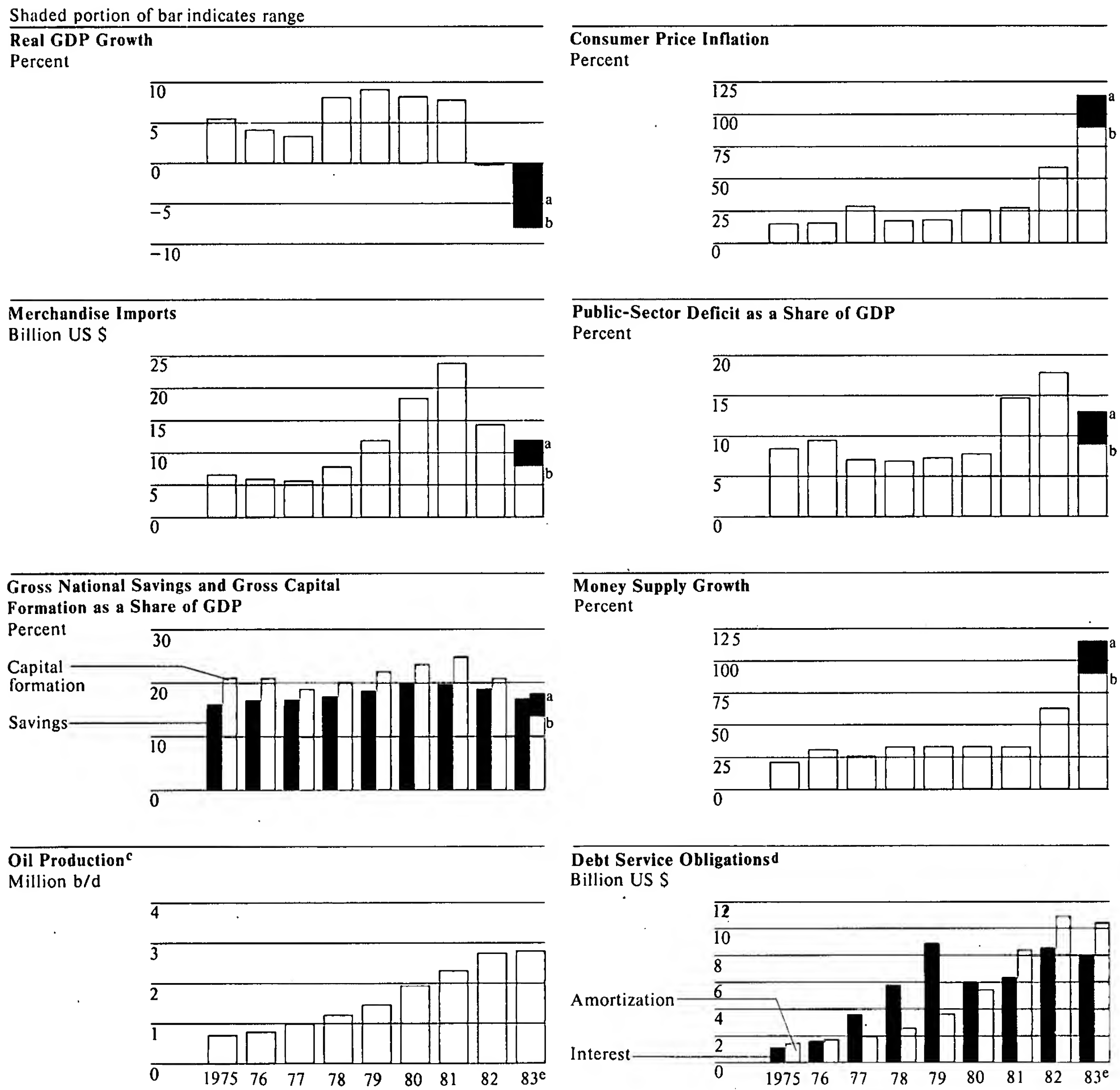
private business anticipate losses this year, and that 15 percent were already in liquidation. During the first half of 1983, idle capacity in industry grew rapidly. An industrial survey released in June by the Bank of Mexico indicated that the 163 largest industrial firms were operating at two-thirds capacity, down from 90-percent capacity in 1982. Based on first-quarter data released by the Mexican treasury, we estimate that industrial production dropped at an annual rate of 12 percent during the first half of 1983.

Other sectors are also declining. We estimate that public and private construction activities are off nearly 75 percent. Traditional commercial activities have been cut sharply by the falloff in industrial output and imports and by the higher value-added tax. As a result, barter and underground trade are expanding. The outlook for agriculture is also poor because of falling real farm price guarantees and growing shortages of fertilizers, machinery, and other imported inputs. Even the minerals sector has been hit by sharp budget cutbacks and low world oil prices. 25X1

Investment in all sectors has plunged, contributing both to this year's decline and the setting of the stage for slow recovery later. Depreciation exceeds new capital formation in many firms in industry, construction, agriculture, and commerce, 25X1
Capital goods imports, which previously accounted for more than two-thirds of investment in machinery and equipment, were 90 percent below last year's level in the first few months of 1983, according to official statistics. 25X1 25X1

Employment. In these circumstances, job losses—particularly among unskilled labor—have become severe. Some private-sector economists in Mexico estimate that 1-2 million jobs have been lost since mid-1982 and that unemployment is now in the 20- to 30-percent range. While government authorities claim the figures are much lower, they admitted in May that the unemployment rate had doubled during the last year. The Bank of Mexico survey reports that

Mexico: Economic Indicators



[a] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[b] Assumes Mexico City keeps imports and public spending depressed.
[c] Excluding natural gas liquids.

[d] Interest on all debt, amortization due on medium- and long-term only; in 1982 debt moratorium and private sector arrears lowered actual debt payments $5 billion, in 1983 we expect debt rescheduling to reduce actual payments on interest and medium- and long-term debt by about $7 billion.
[e] Projected.

25X1

300084 7-83

Table 2 *From 1982 levels*
Mexico: Impact of Economic Deterioration, 1983

	Relaxed Austerity [a]	Sticking to the IMF Program [b]
Change in GDP (*percent*)	−5	−8
Job losses	1,500,000	2,000,000
Inflation (*percent*)	115	90
Change in real merchandise imports (*percent*)	−25	−50
Decline in supplies of locally available goods and services (GDP plus exports minus imports) (*percent*)	−7	−13
Change in investment (*percent*)	−15	−35
Change in per capita consumption (*percent*)	−7	−10
Current account balance (*billion US $*)	−0.5	3.5
Free market exchange rates, yearend (*pesos per US $*)	150 to 200	200 to 300

[a] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[b] Assumes Mexico City keeps imports and public spending depressed.

total employment in the largest industrial firms had fallen 28 percent since June 1982, and that 94 percent of the firms indicated that they would further reduce, or hold constant, their work force.

Job losses have thus far been concentrated in the private sector. Based on preliminary official data and US Embassy reporting, we believe government jobs stayed constant or increased slightly because of the $2.7 billion public works program announced by Mexico City last January.

The bulk of the 800,000 or so young Mexicans entering the labor force for the first time are having to resort to make-work or artisan jobs. This swells the ranks of the underemployed—those with part-time, low-paying, marginal jobs. We estimate that those underemployed have grown from 40 percent of the work force last year to about 50 percent this year. 25X1

Inflation. Inflation remains in the triple-digit range, despite the recession and much higher unemployment. In the January-June period, consumer prices rose 41 percent—an annualized rate of 100 percent—fueled by the soaring peso cost of imports, mounting consumer goods shortages, and the still high budget deficit. During the same period, wholesale prices rose substantially faster—52 percent, an annualized rate of more than 130 percent—as a result of raw material shortages, lower input subsidies, and fewer price controls. 25X1

Selling Austerity

Public Relations Efforts

Our analysis of recent public opinion polling indicates that the President's low-key, down-to-business style, his vigorous attack on inefficient policies, and his measures to curb official abuses of power have convinced many Mexicans that belt tightening is essential. To maintain the cooperation of organized labor, business, and the middle class, the government is attempting to improve its reputation for honesty, efficiency, and fairness, and ensure that austerity is shared equally. A vigorous anticorruption campaign 25X1 has targeted even key ruling party loyalists, in part to show that the government too must sacrifice. Moreover, we think the budget-monitoring authority given 25X1 to the cabinet-level Comptroller General has helped keep spending within targets and has moderately reduced official rakeoffs. 25X1

De la Madrid's National Development Plan, published 30 May, is a major effort to retain public support for belt tightening. The plan suggests that 18 more months of tough austerity are needed but that equity will be considered and living standards of the poor improved, in part by eliminating privileges of the 25X1 rich. For example, the plan suggests rural investment will be redirected to less efficient, nonirrigated areas. It also promises improved access of the "great majority" to food, housing, education, transportation, and recreation. 25X1

Private-Sector Hesitation

Private business has been pleased with de la Madrid's lack of rhetoric, his nonconfrontational style, the anticorruption campaign, and wage restraints. Nevertheless, businessmen are concerned about the absence of an explicit role for private enterprise in the development plan. Even though the plan does not specifically call for more nationalizations, many of them believe government ownership of Mexico's productive capacity will increase. Mexican and US economists doubt the government's ability to increase greatly nonoil exports in the short or medium term—as the plan calls for—without substantial support from private business. [redacted]

Winning Over Organized Labor

We continue to believe that retaining support of organized labor remains key to keeping austerity going. Gaining and maintaining unions' support thus far has been—in our opinion—de la Madrid's most notable achievement. Official labor unions have remained quiet, despite the administration's unwillingness to make concessions on wages. In January, minimum wages were raised just 25 percent and in June only 15.6 percent. These increases lag far behind the rise in the cost of living [redacted]

The President also has taken a hardline stance with small Communist-dominated unions. According to press and US Embassy reports, a monthlong strike by nonacademic employees of the National University, organized into Mexico's largest Communist-led labor union, ended in early July without a pay increase for the strikers. The administration was inflexible during bargaining sessions and was prepared to terminate the workers' contracts. Members of another leftist union were undercut by the announced liquidation of the government-owned company they were striking. We believe de la Madrid's maneuvers increase confidence in his ability to handle challenges to the system without resorting to repression. [redacted]

The Cumulation of Pressures

Even allowing for the President's success on austerity so far, we anticipate an easing of the program over the next few months as de la Madrid responds to vocal interest groups and advisers who suggest that the damage to the economy has gone far enough. Government spending is likely to rise, causing Mexico to fall short of IMF targets. In particular, outlays for subsidies will remain high because of the administration's refusal to raise bus or subway fares and an unwillingness to simultaneously adjust more controlled prices. In the face of severe unemployment, strong pressure will be put on the President to avoid cutting the public payroll. In addition, now that the new administration is getting its programs in shape after eight months in office, incentives will grow for the more powerful ministries to use the traditional practice of budget overruns to increase spending. Cabinet officials also are likely to fight to preserve existing programs even as inflation eats away at the real level of services. Meanwhile, any outburst of violence would cause 25X1 funds to be shifted to the police and military budget. This would tend to reduce allocations for other programs and encourage demands to boost overall expenditures. [redacted] 25X1

Limited Progress on Debt Rescheduling

The IMF stabilization package—purchased at the short-term cost of economic austerity and possible social unrest—was intended to open a window to reschedule Mexico's mammoth foreign debt. Nonetheless, debt rescheduling efforts continue to move 25X1 slowly. [redacted] while preliminary agreement between representatives of foreign bankers and 30 public sector agencies has been reached, final terms have yet to be worked out. 25X1 Moreover, previously unreported public sector debt obligations are still coming to light. While we believe most of the public-sector debt of some $67 billion will eventually be rescheduled, few bankers are pleased with the terms offered on $19.5 billion in arrearages and debt payments on public debt due through 1984. [redacted] 25X1

Even less has been accomplished in efforts to restructure private debt. The Mexican Treasury officially 25X1 reported that as of mid-July only $854 million of the $10 billion to be renegotiated had been rescheduled, despite Mexico City's offer to guarantee availability of foreign exchange to pay private-sector debt for

Government Help With Private-Sector Debt Rescheduling

To aid the private sector in reducing debt arrearages, Mexico City established a trust fund within the Bank of Mexico and promised the private sector future access to foreign exchange at subsidized exchange rates. Under the conditions of the program, if a foreign creditor accepts medium- to long-term debt rescheduling, the trust fund called FICORCA (Foreign Exchange Risk Coverage Trust Fund) establishes dollar escrow accounts payable to the foreign creditor in exchange for peso deposits by the Mexican debtor. The escrowed accounts earn interest and the Bank of Mexico guarantees that these accounts will be paid out to service specified debt obligations as they come due. While FICORCA will administer the accounts and accept exchange risk for the funds in escrow, it will not guarantee or accept commercial risk on the debts. [redacted]

The Bank of Mexico offers different mechanisms to restructure private-sector debt. For supplier credits in arrears, FICORCA sets up escrow accounts converting pesos at the controlled exchange rate, currently about 20 percent below the free market exchange. FICORCA will pay off the accounts that were set up by 15 July and total some $370 million by next spring. Other supplier-credit arrearages—totaling as much as another $4 billion—will be paid off later, depending in part on the availability of foreign exchange. On the other hand, the Bank of Mexico has announced that the small amount of supplier credits coming due during the remainder of this year will be serviced as originally scheduled. [redacted]

Using FICORCA Mexico City worked out debt rescheduling in late June for nearly $2 billion in private-sector credits guaranteed by foreign governments. The resulting agreement reschedules over six years (including a three-year grace period) medium- and long-term principal and interest unpaid as of 30 June and principal payments due during July through December 1983. Arrears on short-term debt will be paid over the next three years, and short-term debt due after 30 June will be paid on schedule. Principal payments due in 1984 will be rescheduled on similar terms at the end of 1983, according to Mexican officials. Under the June agreement, the debts will be repaid if the private firms deposit pesos with FICORCA at the controlled exchange rate. [redacted] 25X1

25X1

For some $10 billion of other private-sector debts past due or maturing by the end of 1984, FICORCA will provide future dollars at an exchange rate from 20 to 30 percent below the controlled exchange rate depending on the length of rescheduling. This allows foreign exchange purchases from 40 to 45 percent below the free market rate. A multiple option program allows companies with current peso liquidity to make full payment for dollar contracts upfront. It also permits other companies that can demonstrate long-term solvency a peso-loan mechanism to pay for contracts over the long term at commercial rates of interest. [redacted] 25X1

25X1

loans rescheduled over six to eight years. [redacted] 25X1
[redacted] foreign creditors are resisting stringent Mexican Government requirements, while many Mexican and foreign businessmen doubt the administration's ability to deliver promised foreign exchange, citing its earlier failures to live up to commitments. The recent headway on Mexico's foreign accounts has encouraged the international financial community somewhat, but, because of the continued capital flight and problems in reducing debt arrearages, bankers remain skeptical about the government's ability to provide foreign exchange to pay private debt obligations. [redacted] 25X1

25X1
25X1

At the same time, Mexican authorities are moving up some repayments to foreign suppliers because of the lighter-than-expected participation by Mexican firms in the government's scheme to reduce private-sector supplier-credit arrearages. [redacted] that escrow accounts for only $370 million of $4 billion in registered supplier-credits had been set up by the 15 July deadline set by the Bank of Mexico. To pay off escrowed balances, Mexico City will remit some $185 million on the fifth business day in September to foreign suppliers and the remainder on the fifth working day in March 1984. US Embassy officers report that participation in this debt rescheduling scheme was low because of:

- Insolvency or illiquidity of many Mexican firms.
- Reluctance of foreign creditors to go along with the plan.
- Some direct debt reductions by Mexican firms with access to foreign exchange.

Financial authorities also announced that a new program will be developed soon to help those Mexican firms that did not participate in the first program. [redacted]

While Mexico has largely stayed current on public-sector interest obligations, the substantial interest arrearages owed by the private sector continue to grow. Over the last six months, government efforts to help the private sector reduce arrearages on interest obligations have been only partially successful because of the illiquidity of many Mexican firms and government foreign exchange shortages. As a result, we estimate that the past due interest on private-sector debt during this time rose by $200 million to some $1.2 billion. [redacted]

Outlook for the Remainder of the Year

We project that the economic decline will persist throughout this year, whether de la Madrid responds to cumulating pressures and eases up on austerity or not.

- If Mexico City fails to make sufficient additional cuts in public spending to meet the targets—and we put the odds at a little better than even that it will—GDP would decline 5 percent and consumption would dip 7 percent.
- On the other hand, if de la Madrid moves to maintain austerity, we see GDP falling 8 percent this year and personal consumption plummeting 10 percent. [redacted] 25X1

25X1

Current estimates of changes in key economic variables by US econometric services and by the Mexican Government are nearly, but not quite, as pessimistic as our own. The US econometric services have substantially increased their forecasts of economic decline within the past two months because Mexico has held imports far below expectations. While the IMF has also significantly altered its foreign trade estimates, it is still holding to its initial economic growth and inflation projections. [redacted] 25X1

25X1

The Relaxation Case

By relaxing austerity to boost imports and spending, we believe that Mexico City can stem—but not halt—the steep slide in the economy by the end of the year. Divisions among government officials over whether this should be done are growing. The sharp drop in imports this year could be slowed by using foreign exchange reserves gained in the first half of the year and a renewing of a few trade credit lines. This would relieve certain critical shortages and enable some plants to raise production slightly. Even so, import volume is likely to be at best 25 percent below last year's result and nearly 60 percent lower than the 1981 level. We would expect most businessmen to maintain a "wait-and-see" attitude before making substantial new commitments to purchase raw materials, intermediate goods, and spare parts abroad because they are still suspicious of de la Madrid's commitment to private enterprise. [redacted] 25X1

25X1

25X1

As we note above, we believe it more likely that the government itself would provide the principal stimulation to the economy. Increasing public spending enough to boost the budget deficit as a share of GDP 3 or 4 percentage points from the current 10-percent rate would slow the decline in economic activity by about one-third for the year. Higher public spending would spur both investment and consumption. We

Table 3
Forecasts of Key Economic Variables, 1983

	Changes in GDP (*percent*)	Inflation (*percent*)	Current Account Balance (*billion US $*)	Imports (*billion US $*)	Exports (*billion US $*)
Data Resources [a]	−4.4	110	−2.9	13.2	21.1
Wharton Econometric Forecasting [b]	−5.1	101	−0.8	11.8	20.6
Mexican Government [c]	−2 to −4	77	−1.0	13.8	22.3
International Monetary Fund [d]	NEGL	55	−2.0	14.5	22.6
Central Intelligence Agency	−5 [e] −8 [f]	115 [e] 90 [f]	−0.5 [e] 3.5 [f]	12.0 [e] 8.0 [f]	21.8 [e] 21.5 [f]

[a] *Latin America Review*, Second Quarter 1983, Data Resources, Inc., June 1983.
[b] *Latin America Outlook*, Summer 1983, Wharton Econometric Forecasting Associates, July 1983.
[c] From National Development Plan, May 1983.
[d] IMF Staff Report, 9 May 1983.
[e] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[f] Assumes Mexican City keeps imports and public spending depressed.

25X1

believe, however, that any substantial rebound in government spending would aggravate inflation and boost the increase in consumer prices to an annualized rate of 130 percent in July-December. This would lengthen the period required to wring out the economy, and postpone the beginning of economic recovery beyond 1984.

Sticking to the IMF Program

If de la Madrid stands firm on austerity, import volumes would stay at rockbottom, and the economic slide would accelerate. In this case, we project real imports in 1983 would fall 50 percent below last year, and almost 75 percent below the 1981 level. While industries would continue drawing down nearly depleted inventories, capacity utilization would drop to less than half. As a result, locally available supplies of goods and services would decline further.

With continued budget cuts and the contraction of demand, we expect inflationary pressure would ease somewhat, and the increase in the cost of living would rise at an annualized rate of 80 percent for July-December. This, along with a more favorable foreign exchange position, would make it possible for solid economic recovery to begin by late 1984.

25X1

25X1

Implications for the United States

Prospects for prolonged austerity, a continued falloff in consumption, and mounting political pressures will cloud US-Mexican economic and political relations for at least the next two years. Despite substantial

25X1

improvements in bilateral economic relations since de la Madrid took office last winter, grating bilateral episodes—such as an expropriation of properties owned by US firms or additional debt moratoria—are still possible, particularly if the United States is blamed for increasingly poor economic performance. [redacted] 25X1

We believe Mexico City's principal bilateral concern will still be to preserve Washington's backing in the international financial negotiations. De la Madrid has indicated his gratitude for the US initiative in arranging new financial credits and the progress on debt relief. Mexico City expects US officials to back its efforts to maintain austerity with additional credits from the Commodity Credit Corporation and Washington's help in restoring trade credits. In addition, Mexico will call for the United States to intercede with the IMF and international banks if it seeks to adjust the stabilization program and to obtain new loans over the next few years. [redacted] 25X1

US-Mexican economic relations will suffer in several areas. We expect private-sector Mexican bankruptcies to cause US banks to write off $3-4 billion in bad debt over the next year or so. US exports to Mexico—our third-largest trade partner—will fall by $4-5 billion this year, after dropping $6 billion in 1982. US-owned businesses in Mexico that produce for the domestic market—the majority of the $7 billion US investment—will continue to face poor demand, and many will pull out because of mounting losses. Meanwhile, illegal migration to the United States will remain at record levels.[1] [redacted] 25X1

On the positive side, US-owned assembly operations along the border that process goods for reexport to the United States will increase profits because of lower real wages and the weak peso. During the next several years, the Mexican Government will be taking steps to keep US businesses operating so that the companies' home offices will still subsidize Mexican losses. Mexico City has already announced that to spur increased production for exports it will adjust rules and interpret its foreign investment laws liberally. [redacted] 25X1

[redacted] 25X1

Sanitized Copy Approved for Release 2011/01/10 : CIA-RDP84S00552R000300170004-6

Appendix

Methodological Notes on Economic Forecasts for 1983

Our economic projections for 1983 are derived from analysis of official Mexican Government projections, IMF data, and recent forecasts published by major US econometric forecasting companies. Econometric models have become conventional tools for analyzing market economies like Mexico's. In a system of equations, these models combine a theoretical representation of the economy, a statistical analysis of the key relationships, and assumptions about government policies and external events. The solution of the system of equations produces conditional estimates of the future; comparisons of separate runnings under different assumptions can be used to determine the sensitivity of the economy to alternative future conditions.

The deterioration in Mexico's economic performance this year reflects the continued sharp reduction in imports that began last year. While the import plunge was primarily caused by a drying up of international bank credits and the sharp devaluation of the peso, the 15-percent decline in the OPEC oil sales price last winter also constrained Mexico's import capacity. Imports dropped $4.5 billion in the first half of 1983, on top of a $9.5 billion cut during 1982.

Our economic projections for 1983 are based on two import and government spending scenarios for the remainder of this year. We believe that the chances are slightly better than even that Mexico will relax austerity and boost imports and spending to keep the fall in employment and consumption to more politically acceptable levels. It is also quite possible—based on policymaking decisions to date—that de la Madrid will maintain tough austerity and stick to the IMF program.

Relaxed Austerity Case

In the more likely case, we see Mexico easing up on austerity, regaining some trade credit lines, and substantially boosting imports during the second half of this year. This would relieve some shortages of producers goods and permit some plants to boost capacity utilization. Nevertheless, imports for all 1983 would, at best, remain 25 percent below last year and 60 percent below the 1981 level. Because of continued private-sector skepticism, we expect that the government would have to take the lead in halting the decline in the economy by expanding imports and public-sector spending. A recent survey of business indicated that private firms are planning to cut real investment spending 35 percent this year. 25X1

In these circumstances, recent projections by the Mexican Government and the IMF show higher imports holding the decline in GDP to 0 to −4 percent while inflation slows to the 55- to 77-percent range. Our projections and current projections by US econometric services show a more serious economic deterioration. We essentially agree with Data Resources, Inc., (DRI) and Wharton Forecasting Associates (WEFA), that GDP will fall about 5 percent. To achieve this, Mexican public spending would have to increase. In this case, we see the public-sector deficit as a share of GDP increasing from about 10 percent in the first half of 1983 to about 15 percent in the last half of the year. Even though there would be a small increase in availability of producer and consumer goods, higher spending would fuel inflation; consumer price gains would be more than 100 percent this year. 25X1 25X1 25X1

This drop in GDP would entail the loss of 1.5 million jobs this year. Because of the lack of social services for the unemployed, many of those who lost modern-sector jobs—including virtually all those who are their family's principal breadwinners—would scramble for jobs in lower productive artisan fields or personal services. Most of the 800,000 or so young Mexicans entering the job market for the first time this year would be unsuccessful in finding modern-sector jobs. As a result, both unemployment and underemployment would increase substantially. 25X1 25X1

Sticking to the IMF Program

If de la Madrid holds fast to the austerity program during the rest of the year, we project that the economic slide will accelerate. We and most observers believe this case is somewhat less likely and the US econometric services, the Mexican Government, and the IMF have not yet addressed it. In this case, industrial firms would continue to draw down nearly depleted inventories, capacity utilization would fall to less than half, and industrial production in the second half of the year would decline at an annual rate of some 20 percent. Gross domestic product would fall at an annual rate of about 10 percent. Despite reduced local availability of goods and services, we project that holding the line on government spending would reduce inflationary pressures slightly, and hold average consumer price inflation under 100 percent for the year. [redacted] 25X1

Our results reflect the overwhelming importance of imports to the economy. Official Mexican statistics show that two-thirds of all investment in machinery and equipment in recent years was accounted for by imported capital goods. Imported industrial inputs, many of which are not locally available, make up almost one-fifth of all raw materials and intermediate goods used in Mexican industry. In this situation, disrupted investment would reduce private spending below the level needed to replace wornout capital goods. Because of the deteriorating capital stock and reduced imported inputs, 2 million jobs would be lost this year. [redacted] 25X1

The longer term advantage to the Mexican economy inherent in this case is that the necessary wringing out and restructuring of the economy would be accomplished quickly. By eliminating the factors that contributed to the overheating of the economy—such as soaring government expenditures in the face of a weak infrastructure and limited productive capacity—a sound basis for a return to the moderate economic growth patterns of the 1960s would be established. The faster adjustments are made, the smaller the risk that the sacrifices required of most Mexicans would promote unmanageable unrest. [redacted] 25X1

Sanitized Copy Approved for Release 2011/01/10 : CIA-RDP84S00552R000300170004-6

Sanitized Copy Approved for Release 2011/01/10 : CIA-RDP84S00552R000300170004-6